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Statement by

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of the

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of the

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Statement as presented

Notation Voting

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Mr. Chairman, I am glad to appear before your Subcommittee today to offer the Board's comments on H.R. 5170, the Mortgage Refinancing Reform Act of 1992. The bill would amend both the Truth in Lending Act and the Real Estate Settlement Procedures Act (RESPA) to require good faith estimates of costs in refinancings of home loans within three days after an application has been made. The bill also would add a new section to the Truth in Lending Act to require "prompt" refund of unearned finance charges and insurance premiums when any consumer credit transaction is prepaid; prohibit the use of the "Rule of 78's" method for calculating the amount of finance charges to be rebated in prepayments of precomputed loans and instead require the use of the actuarial method or another method that is as favorable to the consumer; and require a disclosure of the amount due on any precomputed loan to be provided upon the consumer's request. The bill would also amend the Truth in Lending Act to regulate "lock-in" agreements by making a creditor's commitment to a finance charge a requirement of the law, unless the creditor clearly discloses that the offered finance charge is subject to change. It would also permit a consumer to withdraw an application without additional obligation within three days after receiving disclosures. Finally, the bill would increase the amount of civil monetary penalties that could be imposed for violating the act in residential mortgage transactions and refinancings.

NEED FOR ADDITIONAL COMPLIANCE BURDEN

In our view, new regulation, even though well intended, must pass a basic test of balance and reasonableness. Consumer legislation should balance the need to address problems with the cost of such regulation to both consumers and lenders. This is not only in the interests of the economy as a whole, it is also in the interests of consumers. While consumers may benefit in some sense from protective regulation of the consumer credit market, for example, they may suffer if regulation leads to a restriction in the availability of low-cost credit options or if increased costs are passed on to consumers. Provision of additional paperwork in the already paperwork intensive mortgage process is not costless to consumers.

We understand the concerns that may have led to Congress' interest in providing additional early information about costs in refinancings and in restricting certain creditor practices in loan prepayments and in loan term commitments. However, we must express our general opposition to the bill because we think the burden and expense of compliance would outweigh the consumer need for the legislation.

Today, the need to consider the costs to financial institutions resulting from compliance with the myriad of laws that regulate them is vital. Congress recognized this in the Federal Deposit Insurance Corporation Improvement Act of 1991 by calling for the federal banking agencies to study the cost of compliance with banking regulation. Because a significant increase in compliance burden likely would result from enactment of the proposed amendments to the Truth in Lending Act, we believe that a clear need for additional legislation should be established before Congress acts. We do not think that the degree to which problems exist has been sufficiently established to justify additional general regulation in the area of refinancing disclosures, rebate calculation methods, and rate commitments.

The existence of compliance burden does not obviate the need for regulation when there is a pressing need for additional consumer protection. At this point, however, the volume of complaints by consumers does not suggest that such a pressing need exists. Since the beginning of 1991, the Federal Reserve System has registered a total of almost 3,300 consumer complaints on various issues (about half of which were referred to other regulatory agencies). Yet we received only 13 complaints by consumers about various problems in refinancing loans (five related to problems in getting a pay-off amount and only three related to the adequacy of cost information), three complaints about prepayment penalties and no specific complaints about the Rule of 78's rebate method. Further, we have not received many complaints about undue delays in loan processing causing lock-ins to expire. We have recorded only about 18 complaints from consumers asserting delays in loan closings (including loss of locked-in rates). While complaints are not a precise gauge of the extent to which a consumer problem exists, the number of these complaints seems especially small given the great volume of mortgage refinancings during that time.[1] For example, according to data from the Home Mortgage Disclosure Act, in calendar year 1990 over 700,000 (first and second lien) mortgages were refinanced. We estimate that many more were refinanced in 1991.

Based on these numbers, it does not appear that widespread consumer problems exist. In fact, we estimate that we may have received as many complaints from lenders about consumer behavior in refinancings as from consumers about lender behavior in refinancings. For example, lenders complain about consumers who make applications with several lenders, thus burdening them with processing loan applications that likely will not become closed loans. Another frequently mentioned complaint is that consumers threaten to rescind the refinanced loan after closing -- requiring the lender to refund all fees, including fees paid to

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[1]The recent spate of refinancings may be over by the time this legislation could be implemented. The latest refinancing boom seemed to reach a peak in January 1992, when rates for fixed-rate loans were at a low of 8 1/4 percent, and the volume has generally declined since that time. The last refinancing boom was almost three and a half years ago; it lasted a few months from late 1986 to spring 1987. (According to the weekly index of mortgage refinancing activity of mortgage banking concerns, published by the Mortgage Bankers Association, the greatest number of applications for refinancings was during the week of January 17 when the index reached a peak of 1428.40. By the end of January, the index was at 995.30. By the week of April 24, the index had declined by almost 75 percent from the January 17 peak to a low of 341.50.) Because of provisions in the Truth in Lending Act, regulatory changes take effect only on October 1 and must promulgated at least six months before that effective date. Sufficient time also must be provided in advance of these statutory dates to develop implementing regulations and seek public comment. Thus, it is likely that the earliest this law could be in effect is October 1, 1993.

third parties for appraisals and credit reports -- unless the lender negotiates a lower rate.

We also suggest bearing in mind that substantial new requirements already have been imposed on real estate lending during the past few years. For example, only two years ago, Congress amended RESPA to require several notices about transferring mortgage servicing and about escrow account balances. About three years ago, a law was enacted which requires lenders to use only certified or licensed appraisers in most federally related mortgage transactions. Not that long ago, the Truth in Lending Act was amended to require extensive early disclosures and other protections for home equity loans. All three of these relatively new requirements have been identified by lenders as imposing great compliance burdens. And, of course, these requirements were added to the numerous consumer protection laws already governing real estate lending.

Under the Truth in Lending Act, civil liability and statutory penalties of up to $1,000 per loan (and up to $500,000 in class actions) apply to certain violations of the disclosure requirements. Actual damages and court costs may also be recovered for a broader range of violations. The bill would add several new requirements which would be subject to monetary penalties and other penalties in case of successful recovery by a consumer in court. Furthermore, the bill would increase these penalties tenfold for violations of the new requirements. It is critical to consider these potential and substantial financial risks to creditors from noncompliance with the Truth in Lending Act when assessing the burden that could be imposed by the new requirements.

A more desirable, and perhaps more feasible, alternative to extensive new legislation is to encourage greater efforts by lenders to ensure that adequate information is provided voluntarily to consumers about the costs of refinancings and the degree to which a lock-in can be relied upon. After the last refinancing boom in 1987, the Board (along with other government agencies, consumer and industry groups) prepared a series of consumer information pamphlets about refinancings, settlement costs and lock-ins. These information pamphlets were written to explain these subjects and give practical advice to consumers (including a checklist of questions to ask) so they will be armed with adequate information when they shop for, and negotiate, loan terms. For example, "A Consumer's Guide to Mortgage Lock-ins" informs consumers that some lock-ins may expire before closing under certain circumstances and also suggests that consumers carefully monitor the loan processing to help prevent any delays. "A Consumer's Guide to Mortgage Refinancings" describes the types of fees that might be charged and gives a range of their cost. We promoted the availability of these pamphlets in a press conference when they were initially published in June 1988 and again more recently by a press release in February 1992. We have printed 250,000 of these pamphlets to date. They are also available through the Consumer Information Center in Pueblo, Colorado and through the lending industry.

COMMENTS ON PROPOSED AMENDMENTS TO TRUTH IN LENDING ACT

We offer the following comments on the proposed amendments to the Truth in Lending Act:

1. EARLY DISCLOSURES FOR REFINANCINGS

The bill would amend section 128(b) of the Truth in Lending Act to require good faith estimates of disclosures about the cost of credit (such as the annual percentage rate (APR), finance charge and payment schedule) whenever a home purchase mortgage subject to RESPA is satisfied and replaced with another consumer credit transaction. The bill also would require that disclosures for these "refinancings" be given earlier (within three days after application) than is now required. We would like to mention some of the implications of the amendment. Section 128(b), which currently requires early good faith estimates of Truth in Lending disclosures in purchase money mortgages only, represents an exception to the general requirement that loan-specific Truth in Lending disclosures only need to be provided by consummation of the credit agreement (often at settlement). The statute requires disclosures to be given again at consummation if the APR for the loan varies from the early estimate by more than a small percentage. The bill would broaden the category of loans subject to early disclosure (and potentially redisclosure) requirements. Furthermore, as stated above, the bill could also broaden creditors' exposure in litigation.

Although under current Truth in Lending law consumers are not entitled to get estimated disclosures in refinancings of home loans within three days after application, they do get more precise credit disclosures before consummation. In addition, consumers possess another valuable protection under the law. When a consumer refinances a home loan with a new creditor, or increases his or her financial risk when refinancing with the original creditor, that consumer is entitled to the right of rescission. (A consumer who refinances a loan with the original creditor and does not increase the loan amount may not rescind the loan.) The right of rescission allows a consumer to cancel an obligation secured by a principal dwelling for three days after the loan is closed. After rescission, the security interest in the home becomes void and the consumer is entitled to receive a refund of all fees paid to the creditor or to a third party for the loan. Thus, if consumers have been misled about closing costs or finance charges, they have the right to rescind the loan.

The proposed amendment could benefit some consumers by requiring early estimated disclosures. However, in light of the relatively few complaints we have seen about consumer problems with refinancings, we are inclined to think that the existing disclosures and other protections that consumers have under the Truth in Lending Act are probably adequate. If it is demonstrated that there is a widespread problem with consumers being misled about closing costs in refinancings, as suggested anecdotally in a recent newspaper article, a more targeted approach to the problem might be justified -- such as the proposed amendment to section 3 of the RESPA to require good faith estimates of closing costs (including points) within three days after application.

2. RESTRICTIONS ON METHODS OF REBATING FINANCE CHARGES

Proposed section 115 would require prompt rebates of unearned finance charges and insurance premiums upon prepayment of any consumer loan, regulate the methods for computing rebates, and require disclosure of loan balances. The Board testified on a similar bill in the Senate in 1979 and continues to believe that the sum of the digits, or Rule of 78's, method for rebating unearned finance charges may be less fair to consumers who prepay longer term loans in early years than other methods, such as rebates calculated according to the actuarial method. Nevertheless, we do not recommend federal regulation of the manner in which rebates are computed.

Under the Rule of 78's method, the finance charge is earned faster than under the actuarial method. In general, the longer the loan term and the higher the rate, the less favorable the Rule of 78's will be for the borrower who repays early compared to an actuarial method of computing rebates. The Rule of 78's method is not typically used in mortgages where a periodic rate is applied to a declining balance and thus the issue may not be closely linked to the perception of consumer problems in refinancing home purchase loans. (As we mentioned above, we have received no specific complaints by consumers since the beginning of 1991 about the use of the Rule of 78's in prepayments and very few complaints about prepayment penalties of any sort.)

With some exceptions (such as home equity loan restrictions and maximum APR's on adjustable rate mortgages), the Truth in Lending Act generally does not involve the substantive regulation of credit terms, such as the rate of interest that can be imposed or the types of charges that are permissible. Rather, the focus of the act is on ensuring that consumers receive the most important credit information before becoming contractually obligated. By venturing into substantive regulation of credit terms through the Truth in Lending Act, proposed section 115(b) of the bill would depart further from the statute's disclosure orientation.

Traditionally, rebate methods, like other yield-producing terms such as interest rates, the amount of transaction charges and late charges, have been regulated by the states. More than half of the states have either abolished or restricted the use of the Rule of 78's rebate method.[2] Because the states consider all

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[2]We do not have information on the extent to which the Rule of 78's is being used to calculate rebates of unearned finance charges in prepayments. We suspect that it is not used widely in mortgage transactions. Furthermore, the method already is restricted or prohibited in numerous jurisdictions. Based on information in a report by the Consumer Federation of America from January 1992, almost 60% of the states either restrict or prohibit the Rule of 78's method.

determinants of credit in fashioning their laws, they are probably in a better position to regulate permissible rebate methods in relationship to other terms. Moreover, federal legislation prohibiting the Rule of 78's could be viewed as the beginning of federal control of a host of other terms that long have been controlled by the states. Rate (and insurance) regulation has been an important state function and we suggest great caution in overturning this tradition, particularly on a piecemeal basis.

Furthermore, it is uncertain whether the benefit to consumers of restricting rebate methods would exceed the associated costs to consumers because creditors are likely to try to recapture any lost yield -- possibly by assessing greater fees to all borrowers, not just those who choose to prepay their obligations.

The requirement in proposed section 115(c) of the bill would impose an additional burden on creditors. That section requires a disclosure to be provided, within five days of a consumer's request, of the amount necessary to prepay a loan with precomputed interest. We also note that the National Housing Act recently was amended to require creditors to provide a similar statement annually to borrowers on mortgages insured by the Federal Housing Administration. There might be additional burden to institutions from having to comply with two sets of federal requirements on disclosing the remaining principal balances that apply to different categories of loans.

3. RESTRICTIONS ON LOAN TERM COMMITMENTS

The bill would also amend the Truth in Lending Act to ensure that commitments relating to finance charges in mortgage loans will be honored if the loan is closed within a specified time. The bill would also impose additional disclosure requirements on creditors. We would make many of the same observations about these lock-in provisions as we have about the other provisions of the bill. First, the requirements would involve another change in procedures and another new disclosure at a time in which the complaints about burden from compliance with consumer protection laws affecting mortgage lending are significant. Second, these provisions also would expose creditors to substantial additional civil liability risk in litigation by creating a new set of requirements that will be subject to civil liability under the act generally, and by increasing these penalties for violations of the new provisions tenfold. Third, we are not aware of widespread problems with lenders honoring their commitments. And finally, state regulation of loan terms in our opinion is preferable to federal regulation, and we understand that more than half of the states already regulate lock-ins in some manner.

Proposed section 128(e)(1) would further transform the disclosure orientation of the Truth in Lending Act by making breaches of credit contracts a violation of the act. Furthermore, an unintended result of this provision might be that creditors will avoid locking-in any elements of the finance charge and instead make clear that these "offers" are subject to change, as provided in proposed section 128(e)(2).

In another substantive provision, the bill would allow consumers to withdraw their applications within three days after receipt of the disclosures (which are given within three days after application). A consequence of section 128(e)(4) might be that creditors would wait six days after an application is received to begin processing the application (in order to see whether the consumer had mailed in a withdrawal). Thus, the bill could have the effect of increasing the length of time it takes to process a loan application.

CONCLUSION

In our experience, well-intentioned legislation and regulations, particularly as they pyramid one on top of the other, involve a cumulative burden which is sometimes not fully appreciated. With this in mind, Congress has asked the federal banking agencies to study their regulations this year to assess the degree to which they impose unnecessary burdens on depository institutions and to recommend limited revisions designed to reduce those burdens. All of us should be concerned about the expense and burden of new rules when a need for legislation has not been clearly demonstrated. In our view, this need has not been established.